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Investigating the Impact of Threat of Withdrawal of Block Shareholders on the Quality of Financial Information Reporting

Mohammad Hossein Taherzadeh, Hamid Salehi*
Department of Accounting, Yasuj Branch, Islamic Azad University, Yasuj, Iran
*E-mail: hxsalehi@gmail.com

Abstract

The main objective of this paper is to examine the impact of the quality of financial reporting on threats of block shareholders of the companies listed in Tehran Stock Exchange. Therefore, the Herfindahl index is used as a benchmark to measure the competitiveness of block shareholders. Also, the quality of the financial information is also examined from four aspects including discretionary accruals quality, discretionary income, and cash flows over the remaining accruals. The population of this study is companies listed in Tehran Stock Exchange and a sample of 140 companies listed in Tehran Stock Exchange is selected and studied from 2002 to 2012. Multivariate linear regression analysis is used to test the research hypothesis. The research hypothesis testing results showed a positive relation between the quality of financial reporting standards and the threat of withdrawal of block shareholders. Thus, the results showed that the threat of withdrawal of block shareholders as an important factor plays a significant role in revealing by directors.

Keywords: block shareholders, accruals quality, and the quality of financial reporting, Herfindahl index.

Introduction

Shareholders are one of the main users of financial information. Shareholders can be divided into natural and legal persons who are known in financial literature to "institutional investors" (Ebrahimi Kordlar, 2007). The institutional investors of investment firms and other businesses are the ownership of shares of major companies that have a considerable influence on the companies and also have access to the information about the company's future prospects. However, investors and shareholders are considered professionals in their decisions about stock companies. Institutional investors in corporate governance are strong recovery mechanisms that can monitor the company's management, because they can have a significant influence on the management of company and they are in line with management's interests and shareholders' interests. Concentration of ownership is in the hands of institutional investors to control agency problems and improve the protection of the interests of investors (Ebrahimi Kordlar, 2007). Institutional ownership in corporate governance is key factor to the equity. Owners (shareholders) of the company have different rights such as the rights of the selection board which serve as a proxy for monitoring the performance of managers. On the other hand, the major shareholders have a major role in the transmission of information to other shareholders. They can acquire and transmit private information of management information to others (Najjar & Taylor, 2008). Several research results have shown that the corporate governance mechanisms such as ownership structure, board structure, etc. have a devastating effect on the company's performance and value. The corporate governance system could explain the gap between accounting and market measures to some extent. In fact, the main objective of this study is to see how big the threat of withdrawal of shareholders block the quality of financial reporting is. In other words, we look at variables such as ownership and institutional ownership of property managers and shareholders to block what effect the quality of financial reporting. Companies select the quality of their financial information and the disclosure of financial information, the expected benefits against

the costs caused by the high quality of information disclosure measure. Providing high financial information quality may asymmetry the information between companies and their investors and reduces agency costs. Despite these benefits, it is expected that companies disclose information as possible in the absence of any costs, choose the highest level of quality financial information.

Literature Review

There are institutional investors in the ownership structure. Agency theory asserts institutional investors to have incentive and power of monitoring and managing to ensure that the company management is a useful guide. If management does not act against the interests of shareholders, it could change the composition of the board. There are major shareholders in the business unit that are associated with operational decisions and financial compensation. Studies in this area often review the company's stock units and connect the retrospective financial measures (criteria such as efficiency and cost accounting) to the company's operational decisions. Previous researches by studying the market indicated the benefits of the company and directors of an information over other people who are out of the organization. Therefore, there is information asymmetry that affects the major shareholders of companies and their stock performance. The extent of this impact depends on the type of major shareholders in the company. Recent empirical studies indicated that major shareholders are trying to reduce agency costs through confidential information. Brokman and Yan (2009) reviewed major shareholders and specific information of company and found a positive correlation between the presence of major shareholders and the accuracy of the information of companies. They stated that the blocks' shareholders benefit from an advantage over other shareholders in terms of accuracy and confidentiality of information acquisition costs. Firms also have incentives to respond to the demand of users for firm-specific information because they can reduce their capital expenditures by reducing information asymmetry between companies and their investors (Haley & Palepu, 2001; Verrecchia, 2001). It is expected that external demand for financial information takes place in the companies that have a high level of shareholders who want to keep their shares in the long run. Boubakri and Labgvr addressed corporate ownership structure and found that analysts are more willing to prosecute the companies that have centralized ownership structure. Considering previous researches on the effects of different types of major shareholders have shown the effects of ownership structure on corporate information environment and the present study seek to examine whether heterogeneity is a major shareholder of a determinant of information asymmetry firms. Information is based on the idea that major shareholders have an advantage over other shareholders and also argues that these shareholders are seeking confidential information which increases the information asymmetry with increasing heterogeneity of major shareholders. Block shareholders have limited activities and interests of shareholders and managers to align management opportunity and thus they have reduced incentives to manipulate earnings management (Dichev et al., 1996; Farber, 2005).Therefore, it can be expected that the quality of financial reporting has positive impact on block of shareholder of companies. Also, according to economic theory, poor performance management of shareholders leads to their block and they are threatened to sell their shares (Admat and Pfleiderer, 2009; Edmans, 2009; Edmans and Manso, 2011). To prevent the sale of shares by the block shareholders and consequently to reduce the company's stock price, managers tend to align their actions with those of block shareholders (Doo et al., 2014). Recent theories and empirical studies have found that block shareholders influence the company's power (shareholder who owns more than 5% of the company's total shares) by threatening to pull the company. These shareholders have strong incentives to collect private information and attempt to sell their shares when the company believes that they have reached to its intrinsic value. In this

regard, Two and colleagues (2014) also believed that the threat of withdrawal of block shareholders of companies is one of the factors that can change the quality of the data reported by them.

Methodology

The library method is used to collect data from books, magazines and specialized Persian and Latin sites. Companies also have to collect the data needed by using processor and the official website of the Stock Exchange. The data is analyzed by using Excel software, SPSS version 19 and Eviews 7.

This study is done in eleven-year period from 2002 to 2012. The companies listed in Tehran Stock Exchange constitute the study sample. Because there is some inconsistency between members, the following criteria were used to select the sample:

a. The company's fiscal year should be ended in March each year.

b. The financial year of company should not be changed from 2002 to 2012.

c. The available information is needed in order to extract the required data.

d. Companies should be accepted in Tehran Stock Exchange by the end of fiscal year 2002.

e. There should be at least four companies in the case of industry.

f. Banks and financial institutions (investment companies, financial intermediation, holding companies and leasing-in) were excluded because their financial disclosure and corporate governance structures are different.

Variables

Independent variable: The independent variable of this study is the threat of withdrawal of block shareholders of the Company. The block shareholder competitiveness index (Herfindahl index) is used to measure the threat of withdrawal of the company's block shareholders as follows.

$$BHCOMP_{i,t} = 1 * \sum_{k=1}^{N} \frac{Block_{k,i,t}}{Block_{i,t}}^{2} \quad (1)$$

In the above equation، $Block_{k,i,t}$ represents the number of shares held by the block shareholder for firm i in year t and $Block_{i,t}$ represents the total number of shares held by shareholders block.

Dependent variable: The dependent variable of this study is to measure the quality of financial reporting. Four criteria are used to measure the quality of financial reporting which including:

Discretionary accruals (DisTA), the criteria used to measure the quality of financial reporting. Model number (2) in each industry is estimated for each year to measure discretionary accruals:

$$Accri,t = \alpha 0 + \alpha 1(1/TAi,t-1) + \alpha 2(\Delta REVi,t) + \alpha 3(PPEi,t) + \alpha 4(ROAi,t) + \varepsilon i,t \quad (2)$$

In the above model, Accr represents the total accruals, TA represents total assets, ΔREV represents operating income divided by total assets in the beginning of year, PPE shows the net assets, machinery and equipment divided by total assets in the beginning of period, ROA shows the total return on assets (net income divided by average total assets), i represents the company, and t represents the year. It should be noted that in the above model, the non-cash accruals are equal to the change in current assets minus current liabilities' change in non-interest expenses divided by total assets minus tangible and intangible assets amortization expense. The model number (2) measures the discretionary accruals (precaution). In this study, the absolute value of discretionary accruals is considered as a first indicator of the quality of financial reporting.

The second criterion is used to measure the quality of financial reporting. The quality of accruals (DisWCA) is based on a modified model Dechow and Dichev (2002). For this purpose, the model number (3) in each industry is estimated for each year:

$$WCAi,t = \alpha0 + \alpha1(OCFi,t-1) + \alpha2(OCFi,t) + \alpha3(OCFi,t+1) + \alpha4(\Delta REVi,t) + \alpha5(PPEi,t) + \alpha6(DOCFi,t) + \alpha7(OCFi,t^{*} DOCFi,t) + \varepsilon i,t \quad (3)$$

In this model, WCA represents working capital accruals, OCF represents operating cash flows (total gross cost minus depreciation and changes in current liabilities' change in current assets) divided by total assets in the beginning of period , ΔREV reflects changes in annual sales divided by total assets in the beginning of period, PPE represents the net assets, machinery and equipment divided by total assets in the beginning of period, DOCF variable is planar if cash flow from operations is the number one option and zero. Otherwise, i represents the company and t represents the year. Meanwhile, working capital accruals of similar study by Chen et al (2011) is equivalent to the change in current assets other than cash, minus the change in current liabilities, except the current portion of long-term debt divided by total assets in the beginning of period. The model number (3) showed that in accruals error estimation is not associated with operating cash flow and it cannot be explained by changes in income and fixed assets. The remaining amount is modeled as accruals quality. Therefore, what is a negative working capital accrual, is more indicative of the quality of financial reporting. The third criterion is used to measure the quality of financial reporting model (4) which is based on discretionary income. This model is estimated for each year in each industry (Steuben, 2010; Mac Nichols and Steuben, 2008):

$$\Delta ARi,t = \alpha0 + \alpha1(\Delta REVi,t) + \varepsilon i,t \quad (4)$$

In model (4), ΔAR indicates receivables divided by total assets, beginning of period represents the changes, ΔREV represents annual income divided by total assets, beginning of period represents a change, i represents the company, and t represents the year. The remaining model (4) is discretionary incomes (DisRev). Discretionary income is multiplied by model (1). Higher incomes and higher levels of discretionary accruals are indicative of the quality of reporting. The fourth measure of the quality of financial reporting is based on the ratio of the remaining accruals to cash flows (AccrCash) (Borgostahler et al., 2006).To avoid boundary values, the conversion ratio of control and then the model (1) are multiplied, so that higher values represent higher quality accruals.

Control variables

The control variables in this study are as follows: LIQUIDITYi, t: the liquidity index is calculated by dividing operating cash flow to total assets. Log_Assetsi, t: logarithm of total assets at year-end.

ROEi, t: rate of return on equity. Std_ROAi, t: standard deviation of asset returns. Levi, t: long-term debt plus current liabilities (current portion) divided by total assets. Growthi, t: current year sales growth of the company. OCi, t: the company's operating cycle is calculated as follows:

$$OC_{i,t} = \frac{(AR_t + AR_{t\_1})/2}{(\frac{sales}{365})} + \frac{(INV_t + INV_{t\_1})/2}{(\frac{COGS}{365})} \quad (5)$$

In the above equation, AR represents a company's receivables, INV represents the company's inventory, Sales represents the company's sales, and COGS indicates the company's cost of finished goods sold.Capital_Needi, t: percentage change in intake facilities and equity.Invi, t: total inventory divided by total assets.Lossi, t: Percent of the losses of the company or bars are surveyed non-years.

Research hypotheses testing

This section deals with the methods of the research hypothesis testing. The combination of picture and an ordinary least squares regression is used to analyze the data. In this context, the low regression model is used to test the research hypotheses.

$$FRQi,t = \alpha0 + \alpha1(BHCOMPi,t) + \alpha2(LIQUIDITYi,t) + \alpha3(BHCOMPi,t* LIQUIDITYi,t) + \alpha4(Log\_Assetsi,t) + \alpha5(ROEi,t) + \alpha6(Std\_ROAi,t) + \alpha7(Levi,t) + \alpha8(Growthi,t) + \alpha9(OCi,t) + \alpha10(Capital\_Needi,t) + \alpha11(Invi,t) + \alpha12(Lossi,t) + \varepsilon i,t \quad (5)$$

In the top model FRQi,t represents the four criteria of financial reporting quality of firm i in year t and the remaining variables are defined as before. In model (5) coefficient α3 shows the relationship between the quality of financial reporting and the threat of withdrawal of block shareholders.

Results

Table 1 shows the descriptive statistics of the variables. According to this table, the statistics of the variable leverage (LEV) shows that more than half of the company's assets are financed by debt. The mean of the variable ratio of inventory to total assets (Inv) indicates that it constitutes about 25% of the company's assets and inventory. Statistics relating to the variable year sales growth (Growth) shows that the average growth rate is about 25% of corporate sales.

Table 1. Descriptive statistics for variables

Model variables		GROWTH	Loss	Capital Need	OC	Std ROA	ROE	LEV	INV	Accr Cash	Accr Cash	DisRev	DisTA	DisTA
Samples		1400	1400	1400	1400	1400	1400	1400	1400	1400	1400	1400	1400	1400
Mean		0.248	0.275	0.640	0.246	.198	.135	.652	.253	.731	.731	0.210-	0.172-	-0.172
Middle		.198	0.000	.662	.221	.178	0.107	.670	.236	.720	.720	-0.051	0.039-	-0.039
Fashion		0.000	0.000	0.270	0.070	0.060	0.000	0.350	0.000	-1.020	-1.020	-0.940	0.980-	-0.980
SD		0.470	.447	.158	0.133	0.115	.283	.162	0.128	1.622	1.622	.282	0.257	0.257
Coefficient of skewness		7.463	1.009	0.679-	1.022	.919	.109	0.657-	.438	0.152	0.152	1.235-	1.709-	-1.709
Slenderness factor		100.380	0.984-	.074	1.305	.422	0.028-	0.078	0.045	1.737	1.737	0.226	1.861	1.861
Variations		8.630	1.000	0.800	.730	.520	1,550	.880	.730	12.310	12.310	.940	0.980	0.980
Minimum amplitude		0.950-	0.000	0.100	0.070	0.060	0.680-	0.120	0.000	-5.010	-5.010	0.940-	0.980-	-0.980
Maximum amplitude		7.680	1.000	0.900	0.800	0.570	.870	1.000	.730	7.310	7.310	0.000	0.000	0.000
Quarter	.066	0.000	.544	0.144	.132	-0.015	.561	.157	-0.150	-0.150	-0.365	-0.216	-0.216	-0.216
	.198	0.000	.662	.221	.178	0.107	.670	.236	.720	.720	-0.051	-0.039	-0.039	-0.039
	.334	1.000	.757	0.315	.263	0.303	.770	.336	1.563	1.563	-0.001	0.001-	0.001-	-0.001

According to Table 2, the results of the Chow test are used to test the research hypothesis. According to this table, Chow test results show that the hybrid model (Pooled Model) should be used to test hypothesis.

Table 2. Test results Chow

Type of test	Fisher-sectional statistics	Significance level	Test result
Chow test	29.146	0.241	Combined data

Table 3 presents the results of the research hypothesis testing. Given the amount of F statistics contained in Table 3, the level of all the companies which is equal to 3.206, 3.812, 2.708 and 3.633, the models indicate significant at 95%. Moreover, according to the statistics presented in Table 3, Durbin Watson at all times with companies 2.132, 1.995, 2.027 and 2.062 denies the existence of correlation following the disruption components regression. Table 3 shows the coefficients of the regression model to test the research hypothesis and its meaningful level.

Table 3. Results of the research hypothesis

Explanatory variables	Quality of financial reporting standards							
	AccrCash		DisRev		DisWCA		DisTA	
	T-statistics (sig)	Coefficients	T-statistics (sig)	Coefficients	T-statistics (sig)	Coefficients	T-statistics (sig.)	Coefficients
Constant Value	0.975 (0.330)	1.731	-2.538 (0.011)	-0.772	-0.219 (0.827)	-0.030	0.707 (0.480)	0.199
BHCOMP	0.767 (0.443)	0.096	1.324 (0.186)	0.028	1.486 (0.138)	0.014	-0.193 (0.874)	-0.004
LIQUIDITY	0.142 (0.887)	0.018	-0.304 (0.761)	-0.007	-0.684 (0.492)	-0.007	-0.275 (0.784)	-0.005
BHCOMP* LIQUIDITY	3.081 (0.0005)	1.010	3.486 (0.0005)	0.910	3.129 (0.0005)	1.001	3.455 (0.005)	1.009
Log_Assets	-0.848 (0.397)	-0.108	0.767 (0.444)	0.017	-0.217 (0.827)	-0.002	-0.635 (0.526)	-0.013
ROE	-0.622 (0.534)	-0.030	0.207 (0.836)	0.002	0.128 (0.898)	0.0001	-0.506 (0.613)	-0.004
Std_ROA	1.595 (0.111)	-0.805	0.659 (0.501)	0.057	-0.005 (0.996)	0.001	0.087 (0.931)	0.007
Lev	-0.252 (0.801)	-0.102	4.03 (0.0005)	0.278	1.775 (0.076)	0.055	-0.492 (0.623)	-0.031
Growth	-0.524 (0.601)	-0.002	1.124 (0.262)	0.001	0.452 (0.652)	0.0001	0.614 (0.540)	0.0001
OC	-0.184 (0.854)	-0.113	1.115 (0.265)	0.117	0.587 (0.557)	-0.028	-1.004 (0.316)	-0.097
Capital_Need	-1.170 (0.243)	-0.155	0.321 (0.748)	0.007	-1.096 (0.247)	-0.011	-3.0001 (0.003)	0.063
Inv	-0.960 (0.340)	-0.022	-1.063 (0.291)	-0.246	0.160 (0.870)	0.0001	3.790 (0.005)	0.970
Loss	0.510 (0.601)	0.350	1.860 (0.066)	0.186	1.720 (0.090)	0.170	1.170 (0.250)	0.110
Durbin Watson statistic	2.062		2.027		1.995		2.132	
F-statistics and significance levels	0.0005	3.633	0.003	2.708	0.0005	3.812	0.0005	3.206
R2adj	0.005		0.024		0.003		0.003	

According to this table, the significant interaction effect of variable liquidity index and Herfindahl index (BHCOMP * LIQUIDITY) indicates that there is a significant and positive relationship between this variable and each of the four financial reporting quality criteria used in this study at 95%. Based on these findings, the research hypothesis cannot be rejected at the 95% reliability level which means that the threats of withdrawal of block shareholders are the decisive factor in the quality of corporate financial reporting.

Discussion and Conclusion

This paper provided evidence regarding the effect of the threat of withdrawal of block shareholders on the quality of financial information reported by companies. In this regard, this study investigated 140 companies listed in Tehran Stock Exchange in the period from 2002 to 2012. Research hypothesis testing results indicate that the threat of withdrawal of block shareholders has positive and significant relationship with quality of financial information reporting. The results of this hypothesis testing are consistent with the research finding of Doo et al. (2014).This means that the effective participation of stakeholders in the block structure of corporate ownership improves the corporate value, because shareholders seeking profits and better performance and the fulfillment of this goal are influential on the corporate structure of ownership. Also, the centralized ownership structure and purpose of profit lead to more control over the performance and enhance corporate value and quality of financial information reporting. The findings suggest that there are incentives to improve the performance of managers and block shareholders and the ability of discipline managers who do not move in the direction of their interests and this may reflect the fact that block shareholders are actively managed their portfolio and managers are encouraged to make optimal decisions. Also, companies that are present on board of the block shareholders have higher value. In other words, to monitor the management of the block shareholders at the Board of Directors, managers are forced to pay more attention to the performance of the business and increase the company's value and quality of financial information reporting. Shareholders and other users of financial reports consider the presence of a certain number of block shareholders in a company to obtain reasonable assurance about the quality of financial information reporting. Also, it is recommended that the Tehran Stock Exchange considers the laws and regulations in order to determine the quality of financial information reporting and transparency. It is recommended to use other criteria to assess the relationship between threats of withdrawal of block shareholders and quality of financial information reporting.

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